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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-746

EVA GROSSMANN,

Petitioner,

vs.

EDWARD S. REDINGTON, Trustee, and SECURITIES INVESTOR PROTECTION CORPORATION,

Respondents.

On Petition For A Writ Of Certiorari To The United States Court Of Appeals For The Second Circuit

PETITIONER'S REPLY MEMORANDUM

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The briefs of respondents, the Securities Investor Protection Corporation (hereinafter SIPC) and Edward S. Redington (hereinafter Redington) are unresponsive to the questions presented by petitioner and, if anything, further demonstrate why those questions should be decided by this Court. Respondents seek to avoid rather than address the questions presented by attempting to equate petitioner's

claim with other claims that are neither pertinent to petitioner nor before this Court. Those inapposite claims arose out of transactions which are not only factually different from the transaction involving petitioner, but, more importantly, are claims based upon totally different legal principles and contentions. They involved attempts by subordinate lenders to rescind subordination agreements which, if they had not been fraudulently induced, would have been legal and proper. In contrast, petitioner, in legal contemplation, never occupied the status of a subordinate lender. Petitioner's affidavit, which for the purpose of the summary judgment entered in this case must be taken as true, states unequivocally that when she had turned over her entire life savings of $20,000 to the securities broker, nothing was ever mentioned to her of "subordinate debentures", and, if that term had been used, she would not have understood its significance. As far as $5,000 of the above mentioned sum was concerned, no debenture certificate was ever issued to her and nothing was said about any subordination agreement. Furthermore, petitioner never entered into any agreement with Weis Securities Inc., which somehow, in a manner never clarified in the record nor made known to petitioner, had supposedly acquired the business of Weis, Voisin, Cannon, Inc.

But even more important in the evaluation of this case is the blatant disregard with which respondents have treated, or rather failed to treat, the crass violation of the "suitability" or "know your customer" rule (NYSE Rule 405) which, under Section 6 of the Securities Exchange Act, NYSE was and is duty bound to enforce. NYSE approval is necessary to effectuate the sale of subordinate debentures. (See Redington brief, p. 3 footnote 3; SIPC brief, p. 8 footnote 9). By approving the alleged sale of $20,000 of subordinate debentures to a widow with a total

net worth of $30,000, NYSE became an active participant in the fraud perpetrated by the broker upon the widow, thus eradicating any legal basis for a valid subordination agreement. SIPC which, in turn, relies upon NYSE to enforce the securities regulations, componded the wrong by ignoring the violation of Rule 405 and assiduously fighting petitioner's claim. Thus, the securities regulatory system condoned and sanctioned the violation of its rules and acted in clear contravention of both its statutory duties and the purposes for which it was created.

There is absolutely no legal basis or merit to SIPC's attempt to justify the gross violation of the suitability rule (Rule 405) by the unsupported averment that "[t]he importance of the net capital rule far outweighs Petitioner's interest in enforcement of Exchange Rule 405 . . ." (SIPC brief, p. 10, footnote 11). Both of these rules are exchange rules of *equal force and validity* and neither is subordinate to the other; neither the legislature nor the exchanges have enacted the scale of priorities suggested by SIPC. They are not inconsistent with each other, but are both designed to protect investors and must be enforced in a manner where each operates in harmony with the other.

Respondents reliance on *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, 534 F. 2d 156 (9th Cir. 1976) is misplaced since that case is contrary to the position of respondents and the opinion of the lower courts. In *Hughes* the Ninth Circuit stated:

> Section 6 of the Securities Exchange Act imposes a duty upon registered exchanges to enforce the provisions of the Act and the rules promulgated pursuant to it. *To hold that registered exchanges have discretion as to whether those rules will be enforced would leave the exchanges in the societally unacceptable status of private clubs which existed before the passage of the Act. Id.* at 534 F. 2d 169 (emphasis added).

Not only have respondents failed to provide any justification for allowing SIPC to profit at the expense of innocent investors by arbitrarily deciding to enforce one rule and ignore and treat as nonexistent another rule of equal force and validity (see Petition pp. 15-16, and footnote 2 *infra*), but, more importantly, the aforementioned quotation demonstrates the conflict existing between the Second and Ninth Circuits which requires resolution by this Court. The recent amendments to SIPA[1] and the Bankruptcy Act do not detract one iota from the urgency of the resolution of this vital problem affecting the entire securities industry and thereby the national economy. The selective and arbitrary enforcement of statutorily mandated stock exchange rules and the granting of priorities of one rule over the other, not based upon legislative command, is a question which is likely to occur again and again, leading to uncertain and chaotic conditions in the securities market, hence harmful to the entire economy.

Petitioner is clearly the type of investor to whom Congress intended to accord customer protection. The determination of whether a person is a "customer" under SIPA is not to be made simply by a rigid literal reading of the Act, but rather by ascertaining whether that person is the type which Congress intended to protect with "customer" status. *Securities and Exchange Comm.* vs. *F. O. Baroff Co., Inc.*, 497 F. 2d 280 (2d Cir. 1974)[2]; *cf. Huges* vs. *Dempsey-Tegeler & Co., Inc.*, 534 F. 2d 156, 175 (9th Cir. 1976).

1. The amendment to SIPA is also inapplicable because it relates solely to rescission ". . . in a suit between a claimant and the debtor."

2. The same parties who successfully argued against a rigid literal construction of SIPA in *Baroff*, now, when it suits their purpose, argue that a rigid literal construction of SIPA is required.

As set forth in the petition (pp. 13-14), petitioner was clearly a "customer" under SIPA when she turned over to the brokerage firm her life savings with the belief that they would be properly invested. The question presented by petitioner is not whether a person may acquire "customer" status through rescission, but whether the illegal actions of a securities broker and the securities regulatory system's wrongful approval of a sale of securities which is plainly prohibited by an applicable securities regulation, divest an innocent investor of "customer" status. While this question is raised under the provisions of SIPA applicable to the instant case, it is not altered by the SIPA amendments of 1978 (Pub. L. 95-283) (See footnote 1 *supra*).

Furthermore, H.R. Rep. 95-746, 95th Cong. 1st Sess. 33-34 (1977) shows that, contrary to the decisions of the lower courts, Congress intended that anyone who had been fraudulently induced into a subordination agreement by a securities broker may rescind and participate in the liquidation as a general creditor, and not be relegated to the lowly legal status imposed upon petitioner by the lower courts. This report also discloses that Congress intended that if a transaction would deprive an investor of the protection of customer status, that fact must be made clear to the investor at the time of the transaction, *Id* at 34.

SIPA applies as if it constituted an amendment to the Securities Exchange Act and in *J. I. Case Co.* v. *Borak*, 377 U.S. 426, 433, 12 L. Ed. 2d 423, 428 (1964), which involved the Exchange Act, this Court stated:

> [I]t is the duty of the Courts to be alert to provide such remedies as are necessary to make effective the congressional purpose.

In the present case the lower courts refused all of the remedies available to make effective the congressional pur-

pose of protecting investors in general and unsophisticated investors in particular.

SIPC's contention that petitioner may only utilize her common law and state remedies in a separate action contravenes this Court's holding in *Borak*. *Id.* at 377 U.S. 433-435. Moreover, SIPC's contention that there can be no constructive trust imposed because there is no fund of property to which petitioner can trace money, discreetly ignores the fact that under SIPA her money is sufficiently identifiable to be segregated and placed in the "single and separate fund" established by SIPA § 6(c)(B), which under the 1978 amendment is designated "Customer property" [§ 16(5)].

In light of respondents' inability to face the issues presented in the present petition without grossly distorting them and subverting the entire purpose of securities regulation, and because these issues far transcend the factual confines of the case at bar and affect directly the nation's economy, the need for plenary review of the decisions below is clear.

Respectfully submitted,

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